

Theory of the Firm

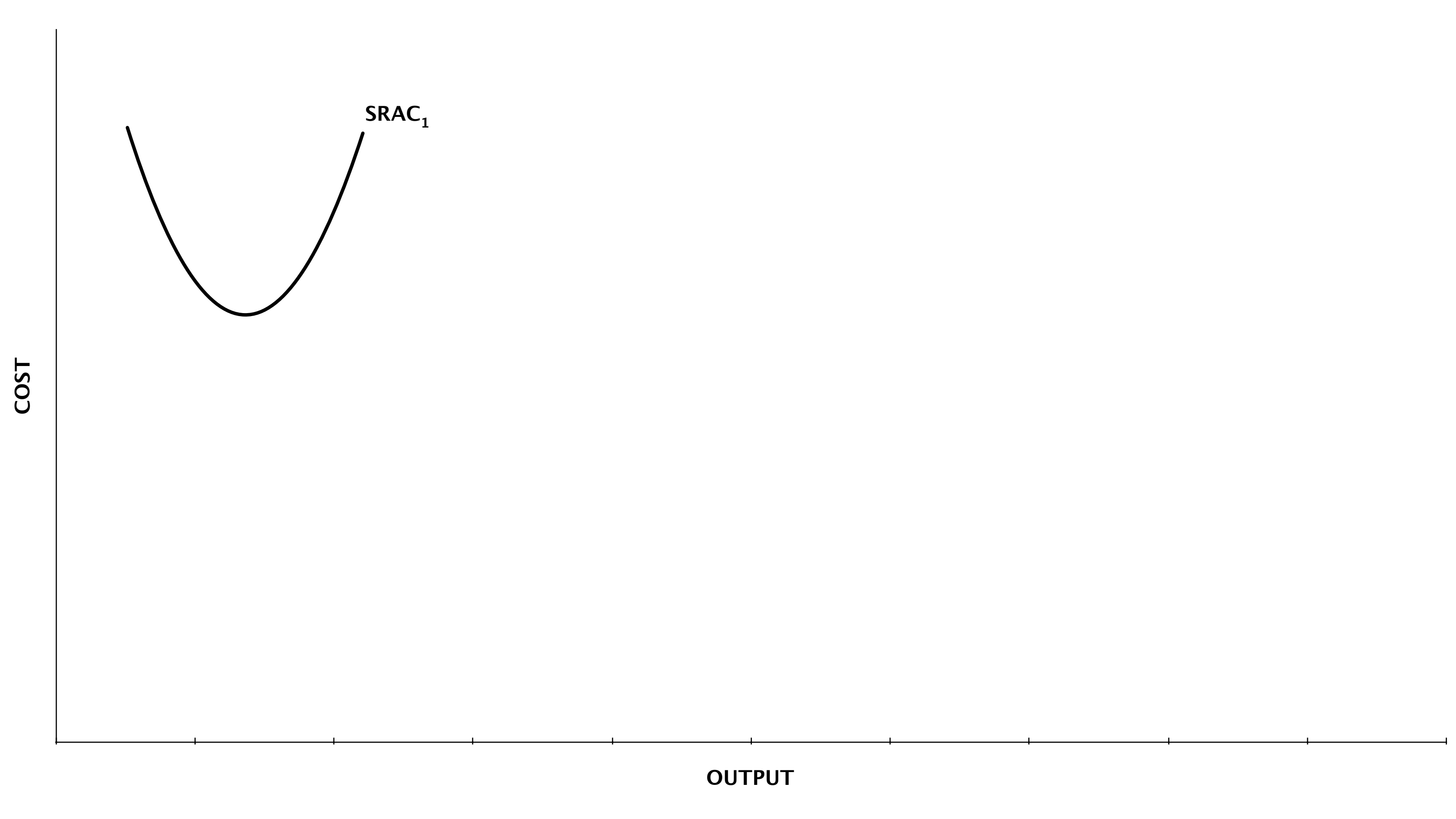
Accounting vs. Economics

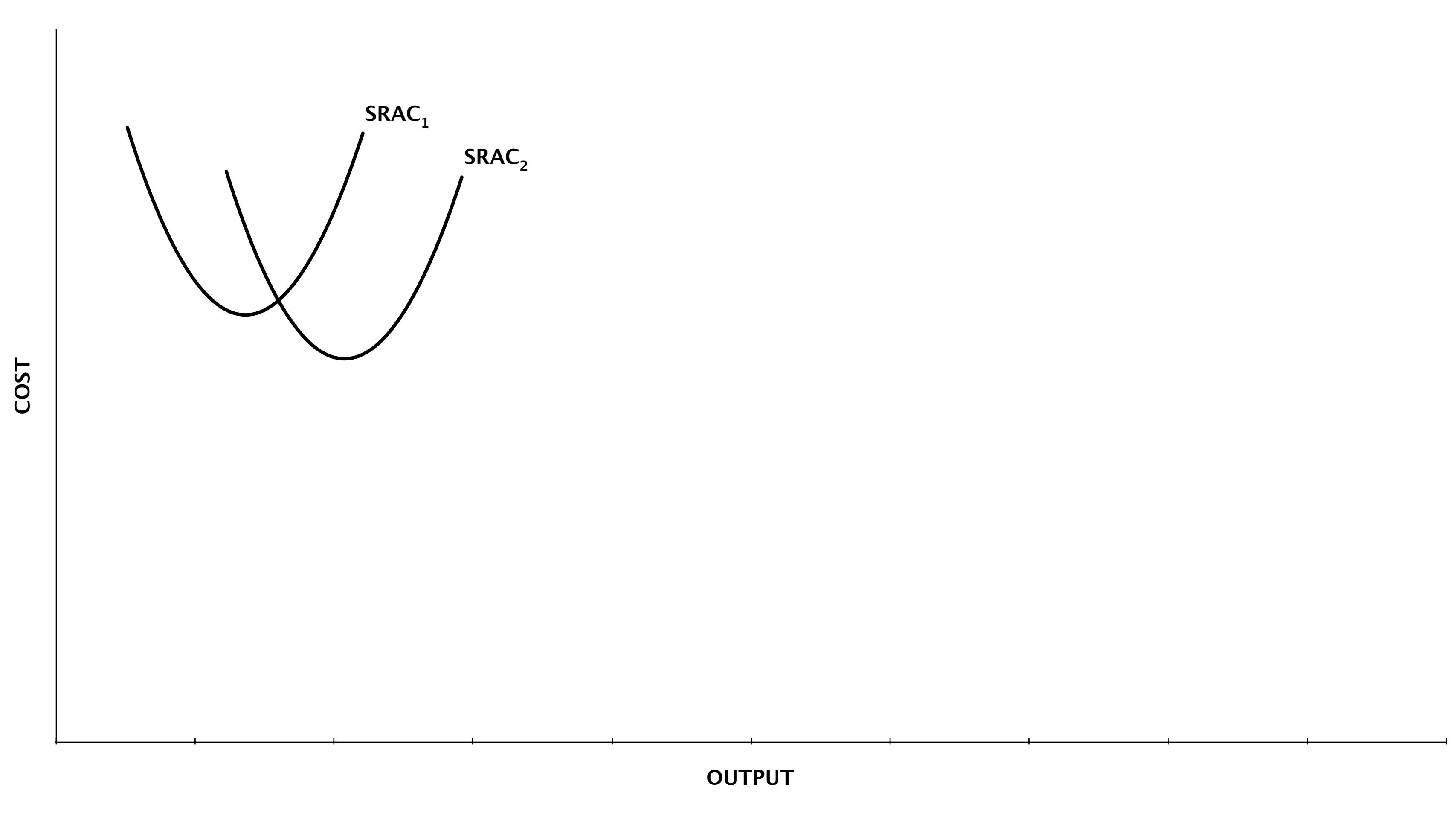
Long-run

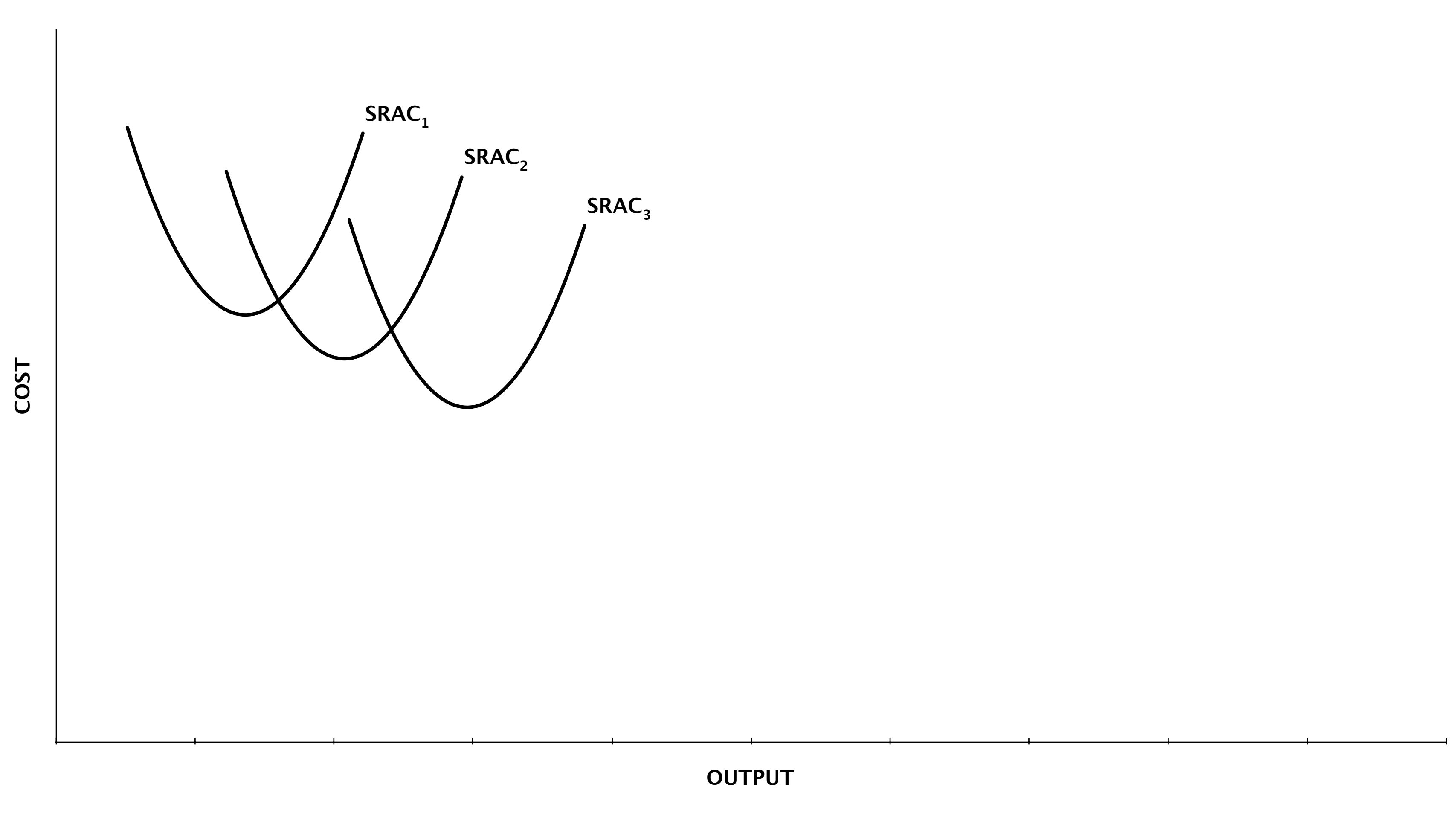
- **accounting profit:** the difference between total revenues and total *explicit* costs
 - **explicit (accounting) costs:** costs which have money value – raw materials, energy, rent, interest, wages
- **economic profit:** the difference between total revenues and the explicit costs and *opportunity cost* of all factors of production

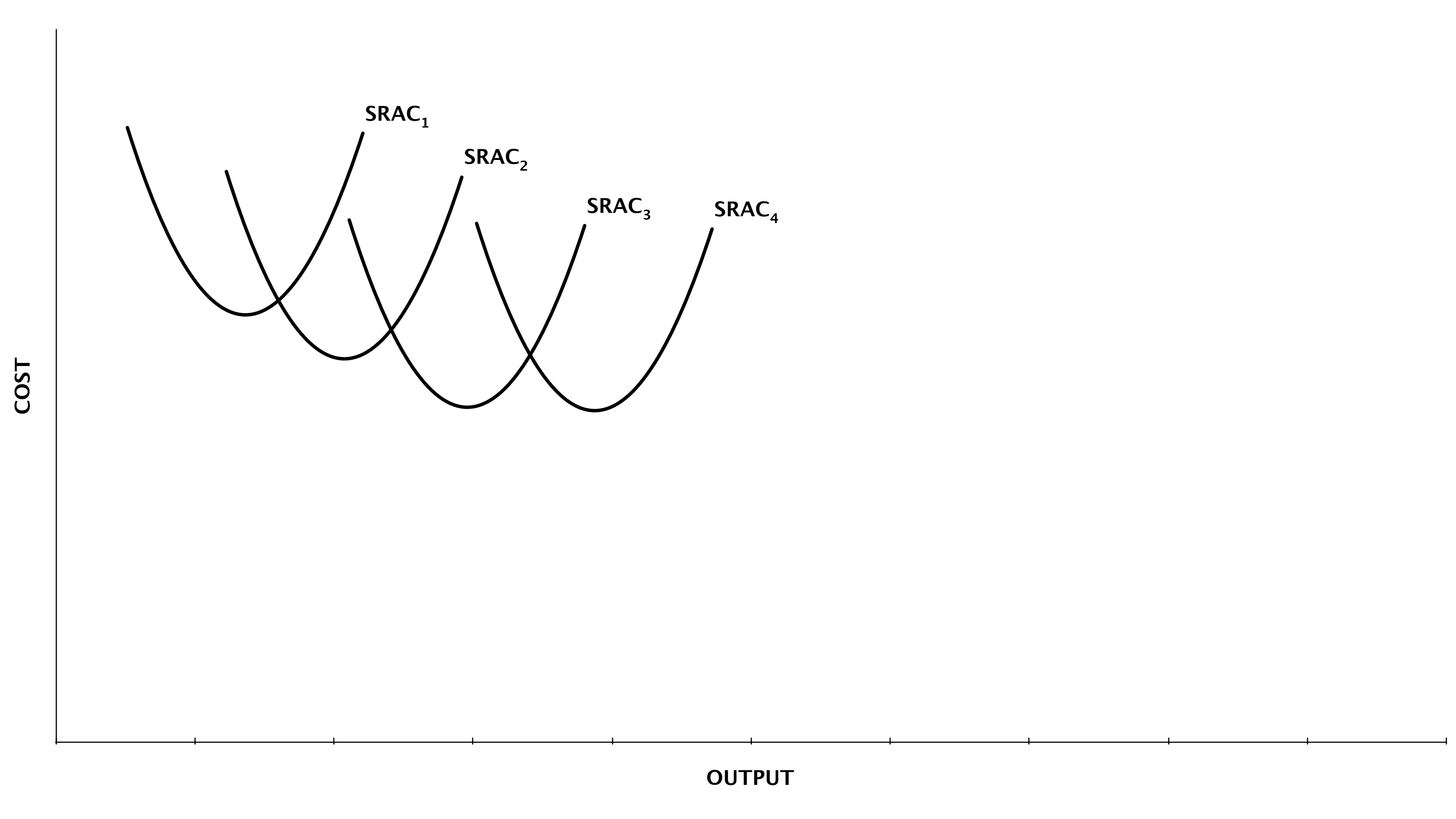
- **short run:** the time period when at least one factor of production is fixed.
- **long run:** the time period when all factors of production can be changed
 - In the long run there are no fixed costs, only variable costs.

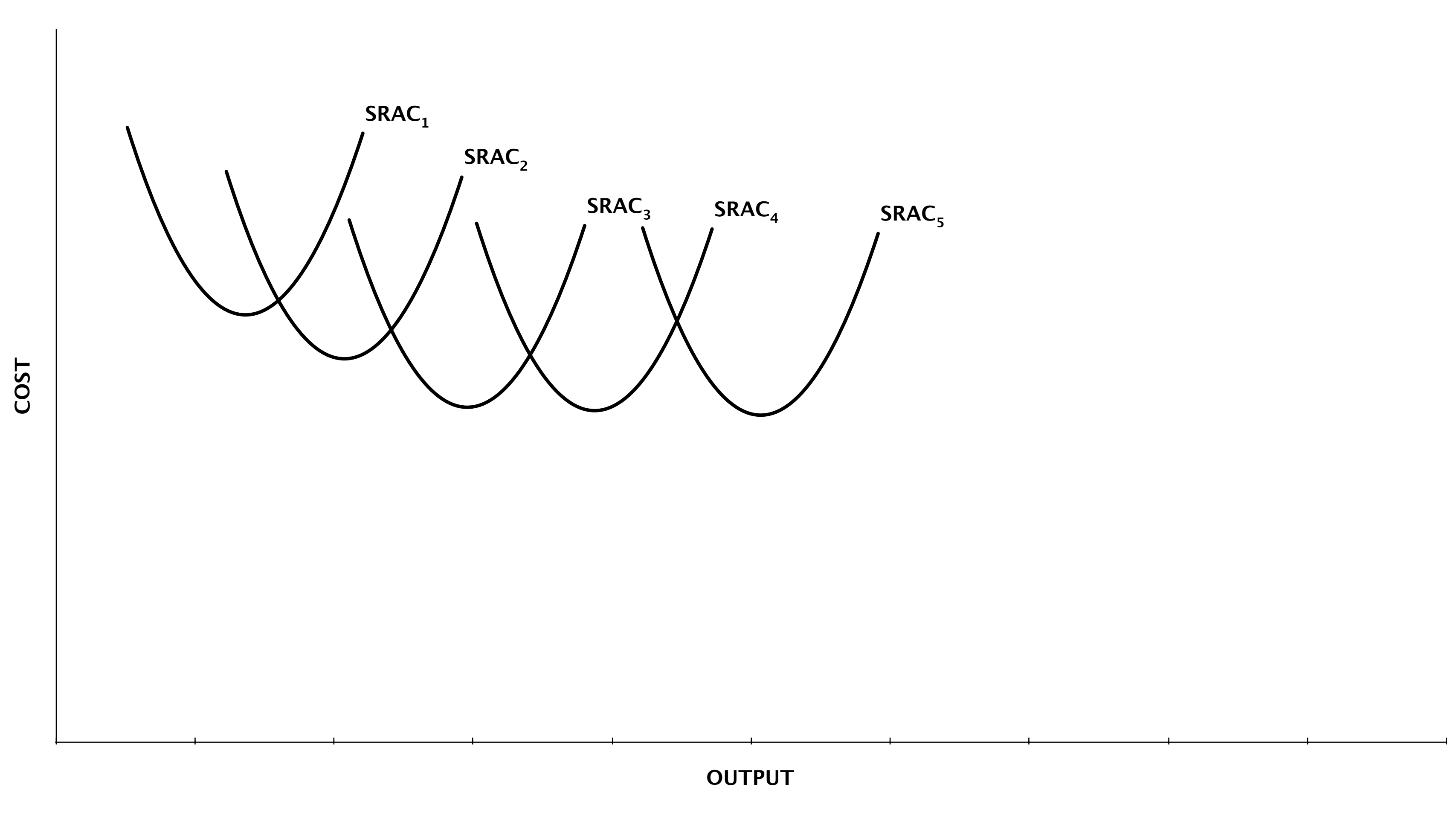
- When inputs are increased in the long run, the output may:
 - increase more than proportionately (add one worker, get five more cupcakes) – when this happens, we say there are “**economies of scale**” or “**increasing returns to scale**”
 - increase proportionately (add one worker, get one more cupcake) – when this happens we say there are “**constant returns to scale**”
 - increase less than proportionately (add one worker, get $\frac{1}{2}$ a cupcake) – when this happens we say there are “**diseconomies of scale**” or “**decreasing returns to scale**”

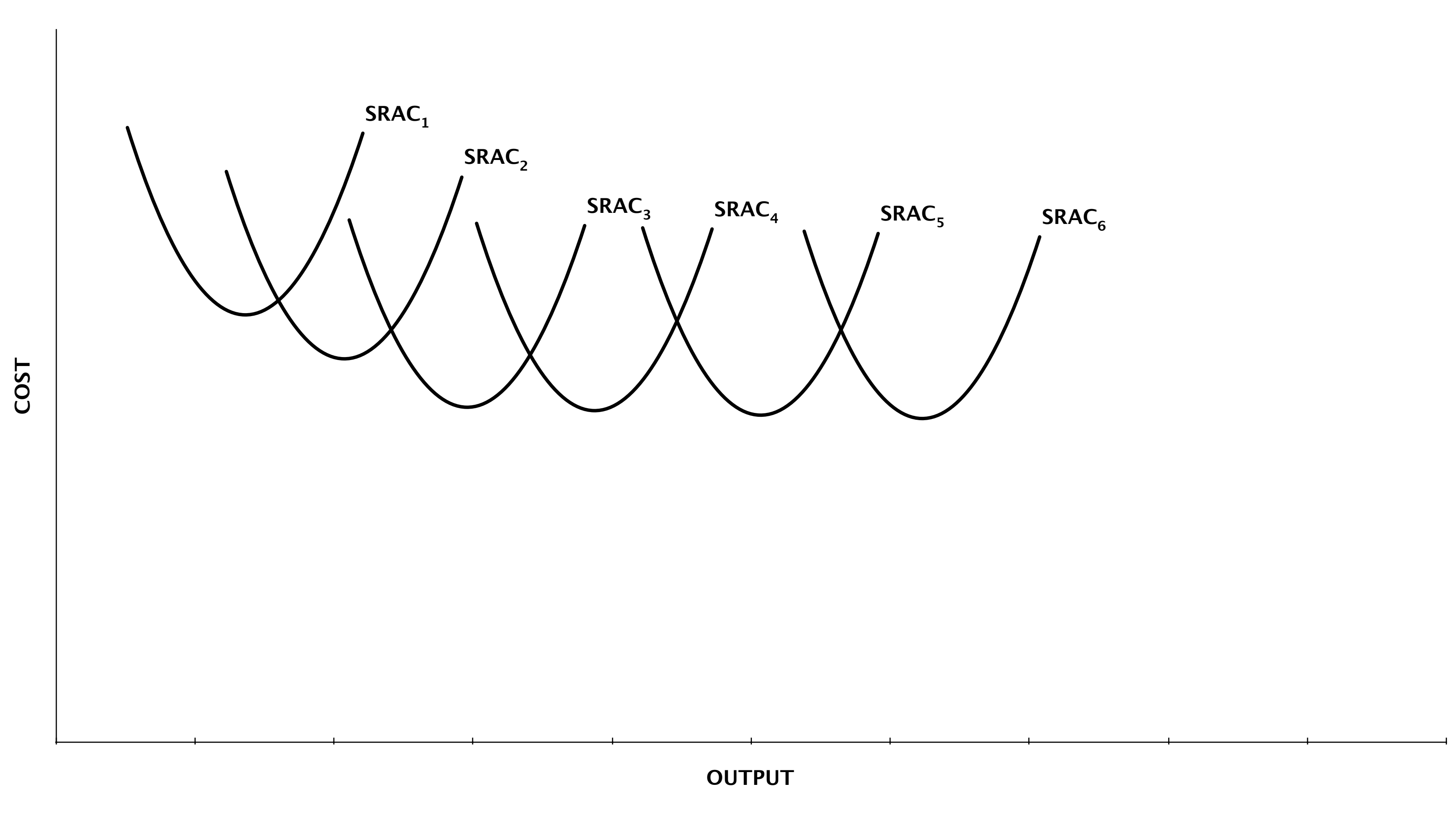


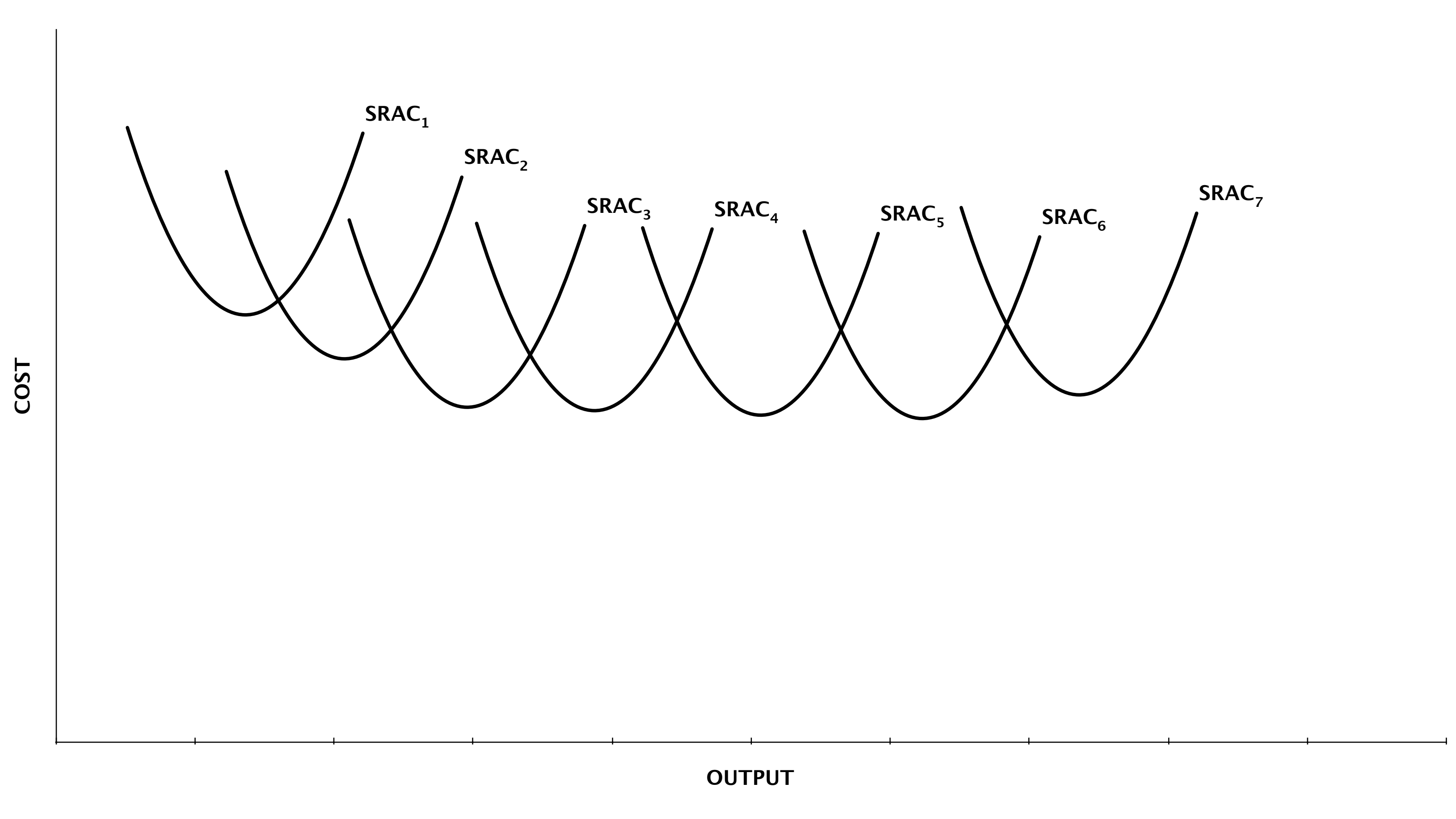


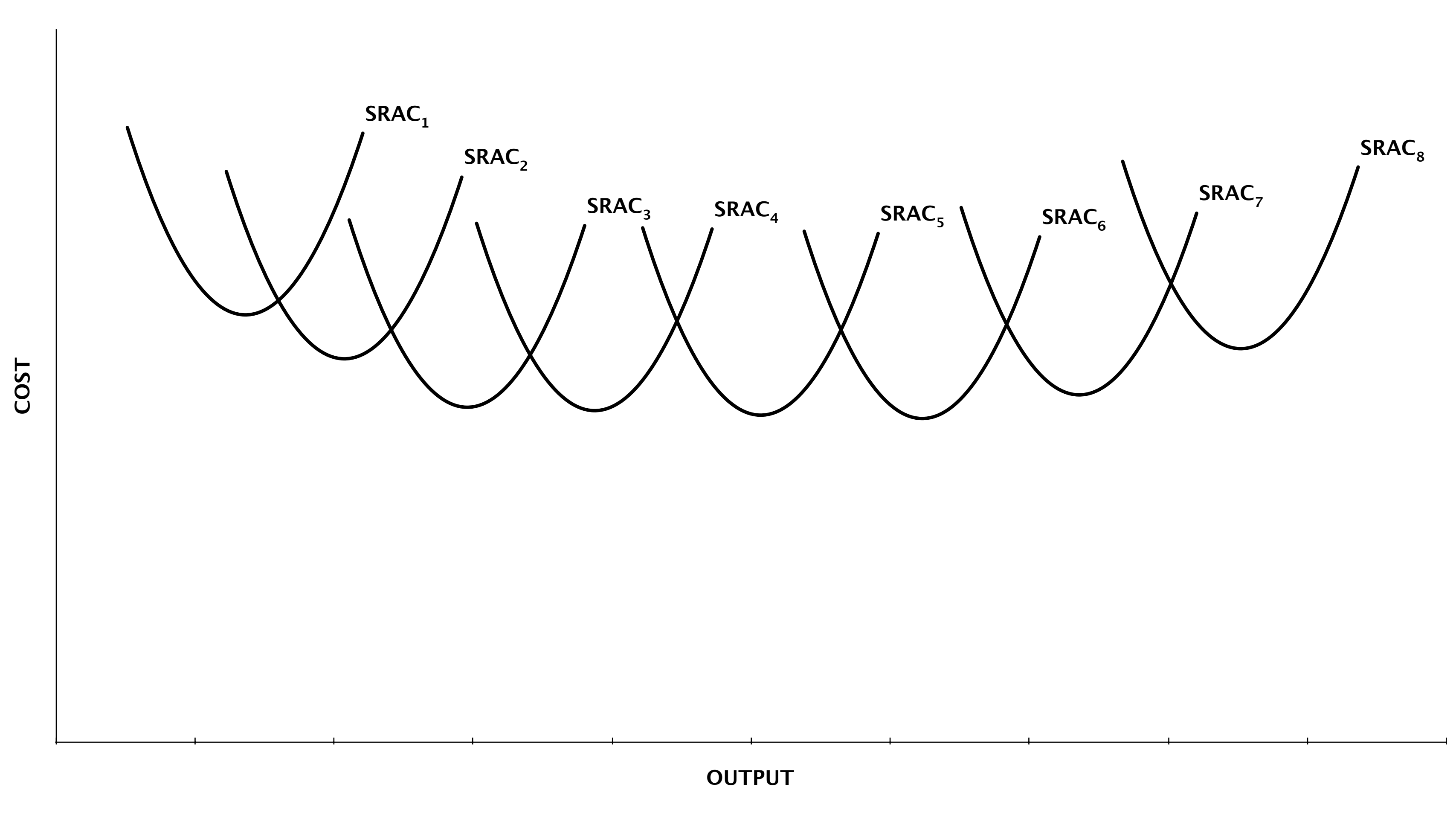


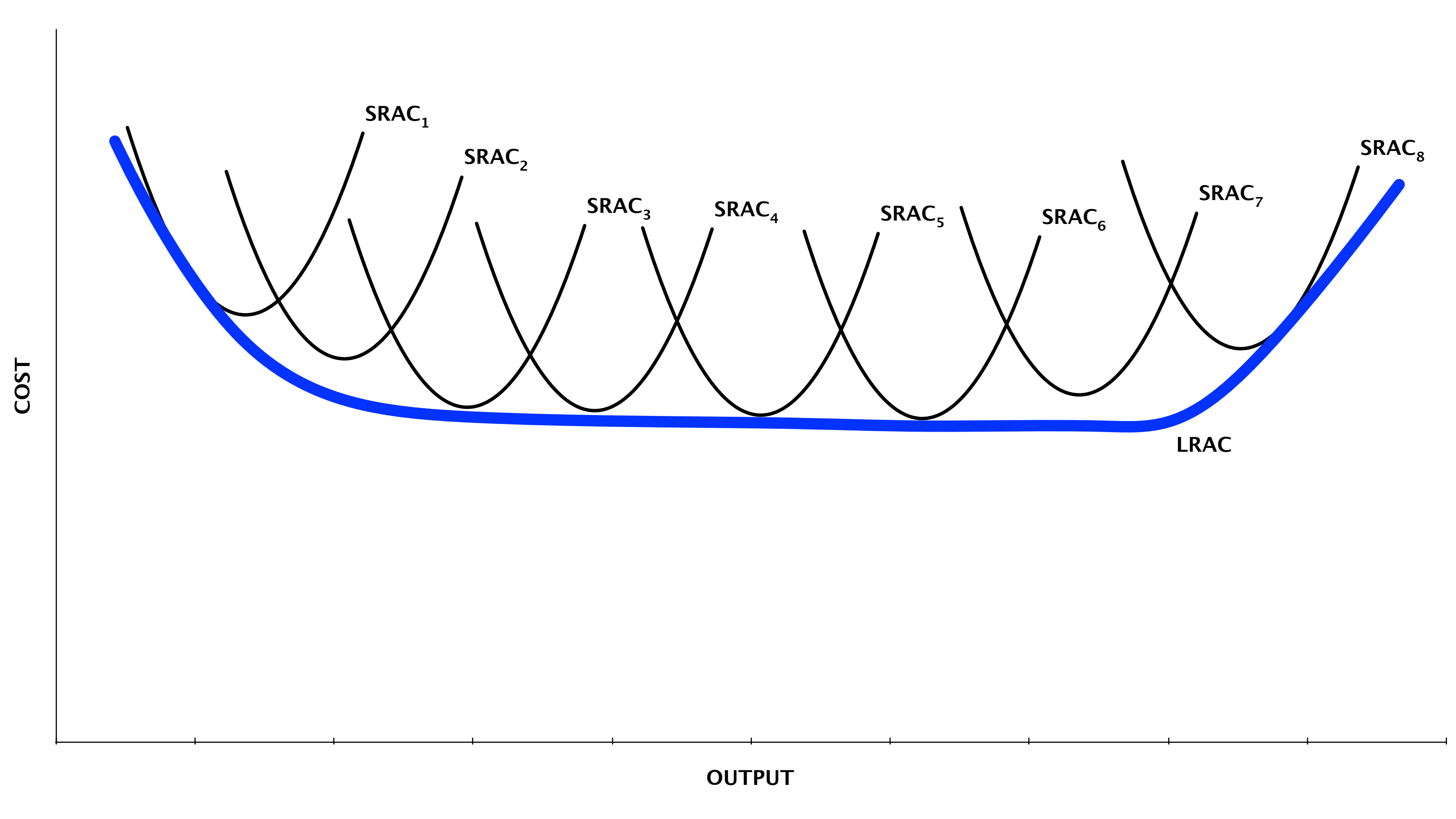


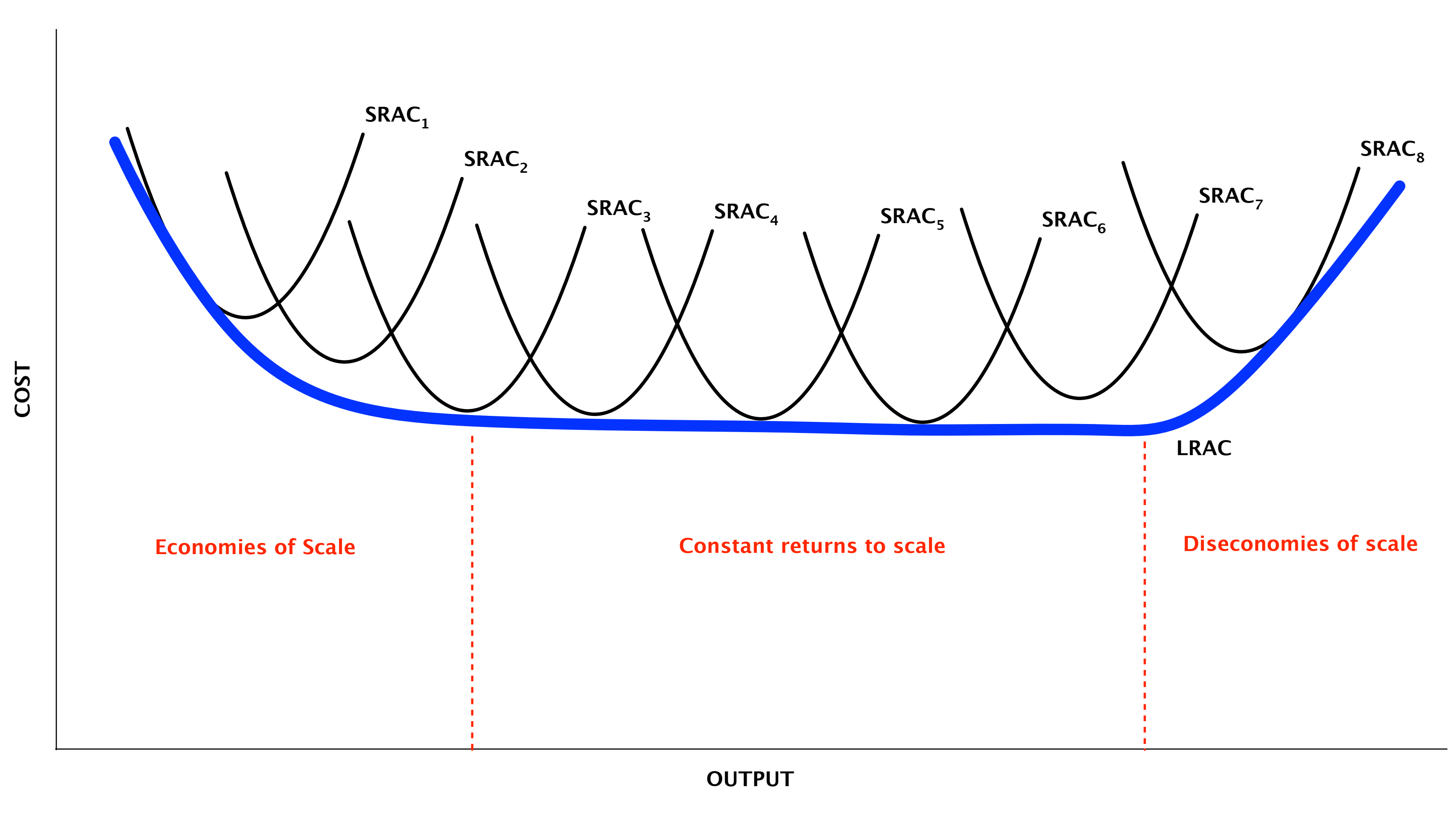












What causes economies of scale or increasing returns to scale?

- Specialization
- Division of labor
- Bulk buying
- Financial economies
- Transport economies
- Large machines
- Promotional economies

What causes diseconomies of scale or decreasing returns to scale?

- Control and communication problems
- Alienation and loss of identity